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In the Supreme Court of the United States

OCTOBER TERM, 1969

No. 678

JAMES G. NASH, ET AL., PETITIONERS

vs.

UNITED STATES

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE PETITIONERS

OPINIONS BELOW

The opinion of the District Court (A. 12)[1] is unofficially reported at 68-2 U.S.T.C. ¶9513 and 22 A.F.T.R. 2d 5202. The opinion of the Court of Appeals (A. 15) is officially reported at 414 F.2d 627 (5th Cir. 1969).

JURISDICTION

The Judgments of the Court of Appeals (A. 20-22) were entered on July 2, 1969. The petition for a writ of certiorari was filed on September 30, 1969, and certiorari was granted on January 12, 1970. The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

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[1] "A" references are to the separately bound Appendix.

QUESTION PRESENTED

Whether taxpayers' partnership realized taxable income in the amount of its reserve for bad debts, upon the transfer of accounts receivable and other assets to newly-formed corporations controlled by it, pursuant to Section 351 of the Internal Revenue Code.[2]

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of Sections 166, 351, 362, and 1016 of the Internal Revenue Code and of the Treasury Regulations promulgated thereunder are set forth in the Appendix hereto at pages 36 to 49.

STATEMENT

Taxpayers (James G. Nash and Birmingham Trust National Bank, as Trustee under the James G. Nash, Jr. Trust and under the Margaret Nash Trust)[3] were partners operating various finance businesses. The partnership used the accrual method of accounting and the reserve method of accounting for bad debts. (A. 7).

On June 1, 1960, the partnership separately incorporated eight of its finance businesses in accordance with Section 351 of the Internal Revenue Code. The taxpayers' partnership received, in exchange for such transfer, stock and securities, including paid-in surplus, representing the net book value of fixed assets, accounts receivable (reduced by the amount of the reserve for bad debts in question)

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[2] All references are to the Internal Revenue Code of 1954, as amended, unless otherwise stated.

[3] We omit reference to Cecelia Nash, who is a party in No. 26,928, only because of the filing of a joint return.

and cash transferred.[4] The corporations continued to conduct the same businesses formerly conducted by the partnership.

The taxpayers, in their partnership return filed for the fiscal year ending January 31, 1961, did not recognize any gain or income upon the transfers to the controlled corporations. Upon the examination of the partnership return, the Commissioner of Internal Revenue determined that the amount of the bad debt reserve ($73,028.05) applicable to the accounts receivable transferred to the corporations on June 1, 1960, should be included as income to the partnership. This adjustment in the partnership income led to tax deficiencies asserted against the taxpayers for the calendar year 1961.

The taxpayers paid the resulting deficiencies and later instituted these suits for refund (A. 11). The three cases were consolidated and submitted to the District Court upon stipulated facts (A. 6) and upon the oral stipulation that the bad debt reserve in question was reasonable in amount. (A. 12). The District Court decided for the taxpayers on the authority of *Estate of Schmidt* v. *Commissioner,* 355 F.2d 111 (9th Cir. 1966) which the District Court found to be precisely in point (A. 12). The Fifth Circuit reversed, finding for the Government on the reasoning expressed by the Tax Court in *Schuster* v. *Commissioner,* 50 TC. 98 (1968) (A. 18).

This Court granted the taxpayers' petition for certiorari on January 12, 1970.

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[4] The Record (A. 7-10) provides a breakdown of the accounts receivable and reserve for bad debts in respect to each of the eight finance businesses. No significance is attached by the parties to the existence of eight transferees, and the question presented is dealt with herein as it applies to the transfer in total.

ARGUMENT

Introduction and Summary

The taxpayers' partnership reflected on its books a reserve for bad debts in the amount of $73,028.05 applicable to accounts receivable on May 31, 1960. The question in this case is whether this reserve for bad debts must be taken into the income of the partnership upon the incorporation of its businesses on June 1, 1960, in transactions qualifying for non-recognition of gain or loss under Section 351 of the Internal Revenue Code.

The taxpayers' partnership operated a number of finance businesses. It used the accrual method of accounting and, thus, recognized income at the time a loan was reflected on its books as an account receivable. Not all loans or receivables were expected to be collected. The taxpayers' partnership accounted for its bad debts, both expected and actual, by use of a bad debt reserve pursuant to Section 166 of the Internal Revenue Code. Under this approach, the reserve was established on the books of the partnership in the amount necessary to reflect the value of its estimated uncollectible accounts receivable. A deduction from income was taken for this amount, and for any subsequent additions to the reserve. The reserve was reviewed annually and additions made thereto as necessary. It has been stipulated by the parties that the amount reflected in the reserve for bad debts in question at the time of the transfer on June 1, 1960 of the businesses to controlled corporations, solely for stock or securities, was reasonable in amount (A. 12).

The statutory scheme for the non-recognition of gain or loss upon the incorporation of businesses is generally contained in Section 351 of the Internal Revenue Code. In summary, it provides that no gain or loss is to be recognized if property is transferred to a controlled corporation solely in exchange for stock or securities. This has been the law,

substantially, since 1921. In 1962 the Commissioner, without prior judicial or legislative authority, took the position that, notwithstanding Section 351, a reserve for bad debts would be restored to the income of a proprietor or partnership, upon the incorporation of its business, on the grounds that the reserve was not transferable and the need for it thereby ceased. Rev. Rul. 62-128, 1962-2 C.B. 139.

The Ninth Circuit, reversing the Tax Court, in 1966 rejected the Commissioner's position in the first case to consider this question, and in the present case, the Fifth Circuit, relying on the Tax Court, approved his position.[5]

We contend that Section 351 precludes the recognition of income by the partnership. The legislative history of this Section, which we review in point I of our brief, shows that Congress provided for non-recognition of gain or loss, as a deferral rather than an exemption from taxation, because the incorporations of existing businesses were "merely changes in form and not in substance, and consequently should not be considered as affecting a realization of income at the time of exchange."[6] This Court considered Section 351, as found in prior law, to be designed to permit such business "readjustments" without the recognition of gain or loss. *Helvering* v. *Cement Investors, Inc.*, 316 U.S. 527 (1942).

As illustrated by this Court in *Helvering* v. *Cement Investors, Inc.*, there exists a close relationship, both in origin and in purpose, between Section 351 covering the incorporation of a business and the provisions of the law relating to corporate reorganizations. Reserves for bad debts are

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[5] *The Estate of Schmidt* v. *United States*, 355 F.2d 111 (9th Cir. 1966), reversing 42 T.C. 1130; *Schuster* v. *Commissioner*, 50 T.C. 98 (1968).

[6] H. Rep. 179, 68th Cong. 1st Sess. 16 (1924); S. Rep. 275, 67th Cong. 1st Sess. 10 (1921).

not taken into income by corporations transferring their businesses in non-taxable reorganizations. The reserve is simply carried over by the corporation acquiring the business. We maintain in point II of our brief that the same rules should apply to transfers of existing businesses under the provisions of Section 351. The Tax Court, relied upon by the court below, distinguished between the corporate organization and the corporate reorganization on the basis that they found what they considered to be specific statutory language allowing the carryover of the bad debt reserve in the reorganization transaction, but could find none for the 351 transfer. The only statutory language that could be pertinent to the reorganization is Section 381 (c) (4) added to the Internal Revenue Code of 1954. This Section requires the acquiring corporation in a reorganization to continue the method of accounting used by the transferor corporation, unless different methods were previously used. Legislative history reveals that Congress passed this Section to clear up uncertainties which had arisen through court decisions at that time, and it was specifically stated that the Section was not intended to be exclusive. Moreover, without specific statutory authority, the carryover of tax attributes from one corporation to another in a reorganization was allowed prior to the enactment of Section 381. See *Helvering* v. *Metropolitan Edison Co.,* 306 U.S. 522 (1939); *Commissioner* v. *Sansome,* 60 F.2d 931 (2nd Cir. 1932). In the 351 situation, the Commissioner has ample authority to require either that the reserve be carried over by the incorporating business or that necessary adjustments be made to clearly reflect income, if it not be. Treas. Reg. Section 1.166-1 (b) (1); *Rooney* v. *U.S.,* 305 F.2d 681 (9th Cir. 1962); *Commissioner* v. *Kuckenberg,* 309 F.2d 202 (9th Cir. 1962).

In the alternative, in point III, we contend that the proper test for restoring the reserve for bad debts to taxable in-

come is one predicated on a recovery by the taxpayer of the amount of the reserve, and not the lack of a need as found by the court below. With the reserve being reasonable, the true value of the accounts receivable was their face value less the amount of the reserve. The value of the stock and securities received by the partnership upon the transfer of the businesses was equal to the net value of the receivables and, therefore, there was not any recovery of the amount of the reserve.

We also urge that the decision of the court below, if not reversed, will paradoxically create income in a tax-free environment, where no income would be realized to a partnership in a taxable transaction if the receivables were sold to a third party at net value—the face value of the accounts receivable less the amount of the reasonable reserve for bad debts. The lower court's result would in effect, create income to the taxpayer where none would have been created if the business had continued in its partnership form and ultimately charged those accounts which became uncollectible to the reasonable reserve which it established. In addition, the restoration of the reserve to income by the partnership and new deductions to the transferee controlled corporation will distort the income of all parties involved in the incorporation of businesses, and will offend the intent and purpose of the reserve method.

I. TRANSFERS TO CONTROLLED CORPORATIONS UNDER SECTION 351 ARE MERE CHANGES IN FORM AND NOT IN SUBSTANCE, AND DO NOT, THEREFORE, GIVE RISE TO INCOME TAX CONSEQUENCES.

The transfers by the partnership to the corporations were in compliance with Section 351 of the Internal Revenue Code (A. 7). Section 351 provides, in the portion pertinent to the issue before the Court, that:

> No gain or loss shall be recognized if property is

> transferred to a corporation . . . by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control . . . of the corporation . . .[7]

With certain changes which are not pertinent to our problem, all of the Revenue Acts enacted since 1921 have contained provisions substantially similar to Section 351.[8]

In the Revenue Act of 1921, Congress first provided for nonrecognition of gain or loss upon the transfer of property to a controlled corporation. Section 202(c)(3). Congress, also for the first time therein, enacted a definition of "reorganization" and provided for no gain or loss upon an exchange of securities incident to such a corporate reorganization. Section 202(c)(2). In addition, Congress provided for nonrecognition of gain or loss upon the exchange of investment property for like kind or use (the forerunner of the present Section 1031). Section 202(c).

Congress' intention in enacting this section is clearly set forth in the following excerpt from the committee reports:

> Section 202 (subdivision (c)) *provides now rules for those exchanges or 'trades' in which, although a technical 'gain' may be realized under the present law, the taxpayer actually realizes no cash profit.*
>
> Under existing law, 'when property is exchanged for other property, the property received in exchange shall, for the purpose of determining gain or loss, be treated as the equivalent of cash, to the amount of its fair market value, if any * * *.' *Probably no part of the present income tax law has been productive of so much uncertainty or has more seriously interfered with necessary business readjustments.* The existing law makes

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[7] Section 351 is set out in pertinent part in the Appendix hereto at p. 38.

[8] The Revenue Act of 1921, §202(c) is set forth in full in the Appendix at pp. 42-44. The sections for the respective years are: Int. Rev. Code of 1939, §112(b)(5), 53 Stat. 37; Revenue Act of

a presumption in favor of taxation. The proposed act modifies that presumption by providing that in the case of an exchange of property for property no gain or loss shall be recognized unless the property received in exchange has a readily realizable market value, and *specifies in addition certain classes of exchanges on which no gain or loss is recognized even if the property received in exchange has a readily realizable market value.* These classes comprise the cases where productive property (other than stock in trade or property held primarily for sale) used in a trade or business is exchanged for property of a like kind or use; where in any corporate reorganization or readjustment stock or securities are exchanged for stock or securities of a corporation which is a party to or results from such reorganization; and *where an individual or individuals transfer property to a corporation and after such transfer are in control of such corporation.*

The preceding amendments, if adopted, will, by removing a source of grave uncertainty and by eliminating many technical constructions which are economically unsound, not only permit business to go forward with readjustments required by existing conditions but also will considerably increase the revenue by preventing taxpayers from taking colorable losses in wash sales and other fictitious exchanges. . . . (S. Rep. 275, 67th Cong. 1st Sess. 10 (1921)); [Emphasis added].

In connection with the review of a corporate readjustment which did not meet the literal language of the reorganization definition under the Revenue Act of 1936, this Court found Section 112(b)(5) of the Act, which is the predecessor of our Section 351, to be applicable and "to permit the

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1938, §112(b)(5), 52 Stat. 485; Revenue Act of 1936, §112(b)(5), 49 Stat. 1679; Revenue Act of 1934, §112(b)(5), 48 Stat. 704; Revenue Act of 1932, §112(b)(5), 47 Stat. 196; Revenue Act of 1928, §112(b)(5), 45 Stat. 816; Revenue Act of 1926, §203(b)(4), 44 Stat. 12; Revenue Act of 1924, §203(b)(4), 43 Stat. 256; Revenue Act of 1921, §202(c)(3), 42 Stat. 230.

deferment of gains or losses where 'there has been a mere change in the form of ownership' or where the taxpayer has not 'closed out a losing venture'." *Helvering* v. *Cement Investors, Inc.,* 316 U.S. 527, 533 (1942).[9]

As this Court commented in that case concerning one of the forerunners of Section 351:

> Its legislative history shows that it was designed to permit 'readjustments' without present recognition of gain or loss by allowing property to be transferred to a controlled corporation by an individual, a partnership, a corporation or others. (p. 533)

In 1924, when considering a new Revenue Act setting forth the provisions for the carry-over of bases of property acquired in the tax-free transfers previously referred to under the 1921 Revenue Act, Congress had occasion to restate the purposes underlying the enactment of these tax-free transfers:

> *The provisions . . . that no gain or loss is recognized from certain exchanges do not grant an exemption and are not so intended. These provisions are based upon the theory that the types of exchanges specified* . . . [§202(c), Rev. Act. 1921] *are merely changes in form and not in substance, and consequently should not be considered as affecting a realization of income at the time of exchange.* In other words, these provisions result not in an exemption from tax but in a postponement of tax until the gain is realized by a pure sale or

[9] This Court cited with approval *Portland Oil Co.* v. *Commissioner,* 109 F.2d 479 (1st Cir. 1940). The First Circuit in *Portland Oil* stated at page 48: "It is the purpose of [351] to save the taxpayer from an immediate recognition of a gain or to intermit the claim of a loss, in certain transactions where a gain or a loss may have accured in a constitutional sense, but where in a popular and economic sense there has been a mere change in the form of ownership and the taxpayer has not really 'cashed in' on the theoretical gain, or closed out a losing venture."

by such an exchange as amounts to a pure sale. It follows, therefore, that in the case of such an exchange the property received should be considered as taking the place of the property exchanged. (H. Rep. 179, 68th Cong. 1st Sess. 16 (1924). See, also, S. Rep. 398, 68th Cong. 1st Sess. 17 (1924).) [Emphasis supplied][10]

The position of the taxpayers is fully supported by the literal language of Section 351. The Section begins with the wording: "No gain or loss shall be recognized *if property is transferred to a corporation. . . .*" [Emphasis supplied] Congress chose the words "if property is transferred" as opposed to "on the transfer of property" or "from the transfer of property." The use of the word "if" connotes *an event* calling for non-recognition of gain, loss or income. It does not simply focus on whether there be gain or loss specifically related to the property involved.

The purpose and meaning of Section 351 had been further manifested by the regulations under Section 453, dealing with the installment method of reporting income. Under this method, taxpayers generally can elect to report gain as cash payments are received, when they fit certain tests provided in Section 453. Taxpayers using the installment method must accelerate their reporting of income upon the disposition of the installment obligation. Section 453(d). The Commissioner's regulations, almost continuously since 1928, have provided that transfers of installment obligations to corporations under Section 351 and in reorganizations, are exceptions to the general rule, and no gain or loss is recognized.[11] The position of the regulations is obviously based on the discussion of the House Ways & Means Com-

[10] This is the forerunner of §362 of the present Internal Revenue Code.

[11] Treas. Reg., §1,453-9(c)(2) was not in Regulation 86 under the Revenue Act of 1932. It did, however, appear thereafter and continuously since that time.

mittee of Section 44(d) of the Revenue Act of 1928, the predecessor of present Section 453(d):

> Whether or not a gain or loss realized under the section is recognized for tax purposes depends upon general principles of law embodied in the income tax provisions, the exchange of installment obligations in connection with tax-free exchanges, for instance being cared for by Section 112. [Section 112(b)(5) was one of the predecessors of Section 351.] H. Rep. No. 2, 70th Cong. 1st Sess. 15 (1927). The same was repeated by the Senate Finance Committee S. Rep. 960, 70th Cong. 1st Sess. 24 (1928).

For many years, the courts sought and did preserve the integrity of Section 351, and the tax-free nature of any transfers thereunder where only stock or securities was received in exchange for property transferred. *P. A. Birren & Son* v. *Commissioner,* 116 F.2d 718 (7th Cir. 1940); *Easson* v. *Commissioner,* 294 F.2d 653 (9th Cir. 1961).[12] We do not mean to imply that every transfer under Section 351 had been insulated by the courts from taxation. But in those cases where tax consequences resulted, the Commissioner was asserting that the transfer produced an unacceptable assignment of income, or the method of accounting previously followed by the transferor did not clearly reflect income. The Commissioner was then relying on Sections 446 or 482 or their predecessors in the law. *Commissioner v. Kuckenberg,* 309 F.2d 202 (9th Cir. 1962); *Rooney* v. *United States,* 305 F.2d 681 (9th Cir. 1962). This is not the position of the Commissioner in our case. There is no contention of any assignment of income or any lack of clarity in reflecting income. The amount of the reserve for bad debts is expressly stipulated to be reasonable. (A. 12.)

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[12] See also *Estate of Willett* v. *Commissioner,* 365 F.2d 760 (5th Cir. 1966) and *Henry McK. Haserot,* et al, 41 T.C. 562 (1964), rem'd., 355 F.2d 200; remanded 46 T.C. 864; aff'd. 399 F.2d 828 (6th Cir. 1968).

With this legislative, judicial and regulatory background, it was understandable why the Tax Bar was surprised when the Internal Revenue Service issued, in 1962, Revenue Ruling 62-128. See Arent, *Reallocation of Income and Expenses in Connection with Formation and Liquidation of Corporations,* 40 Taxes, December, 1962, p. 995. This was the first indication of the Revenue Service's position, although the tax-free incorporation sections and the provision providing for the use of the reserve for bad debts had been in the law for over 40 years.[13]

The reserve method selected by taxpayers' partnership to provide deductions for losses from bad debts had also become a part of the law by virtue of the Revenue Act of 1921. Section 214(a)(7).[14]

The reserve method, as contrasted with the specific charge-off system, is designed to match the bad debt deduc-

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[13] Apparently the tax writers were not aware that any potential problem existed of this nature in a §351 transaction for a representative review of the articles to that time reveals no discussion of the problem. Here is a cross-section of articles dealing with §351, none of which refers to this danger: Darrell, *Corporate Organizations and Reorganizations Under the Internal Revenue Code of 1954,* 32 Taxes, December 1954, p. 1007; Kumler, *Corporate Organizations and Reorganizations,* U. So. Cal. 1955 Tax Inst. 311; Constellow, *Incorporation of the Unincorporated Enterprise,* N.Y.U. 13th Inst. on Fed. Tax (1955) 685; Webster, *A Tax Check List on Incorporation,* 35 Taxes, August 1957, p. 586; Pennell, *Tax Planning at the Time of Incorporation,* 35 Taxes, December 1957, p. 927; Tritt and Spencer, *Current Tax Problems in Incorporation of a Going Business,* U. So. Cal. 1958 Tax Inst. 71; Paul and Kalish, *Transition from a Partnership to a Corporation,* N.Y.U. 18th Inst. on Fed. Tax 639 (1960); Stutsman and Engman, *Tax Factors in Organizing a Corporation,* P-H Tax Ideas, §7006, April 1962.

[14] It was intended to set forth a method of providing for bad debts "much less subject to abuse than the method of writing off bad debts required by the present law." [Prior thereto, debts were to be charged off when worthless.] H. Rep. 350, 67th Cong., 1st Sess. 11.

tion, with the recognition of the accounts receivable into income. Without the reserve method, receivables would give rise to income in one period, but the worthlessness of the very same receivable, when later determined, could only be claimed in the later period. It was to permit the taxpayer to match expenses with income that the reserve method of accounting was authorized. S. Rep. 275, 67th Cong., 1st Sess. 14 (1921) sets forth this intent:

> [L]osses occurring in one year are frequently not determined or sustained until another year, depending upon court decision or the clearing up of uncertainty. To permit more elastic treatment of such losses, in the interest of justice to the taxpayer, it is provided that certain losses shall not be deducted as of the taxable year in which sustained, if, in the opinion of the Commissioner, they should be accounted for as of a different period. . . .

Because it more realistically determines the profit or loss for a given accounting period, the use of the reserve method for bad debts is preferred from an accounting standpoint.[15]

The Ninth Circuit in 1966 was the first appellate court

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[15] Niswonger and Fess, Accounting Principles 226 (9th ed. 1965). The case of *O. P. Lutz*, 29 T.C. 469, 475 (1957) contains the following discussion of the two approaches available for accounting for bad debts:

". . . [T]he Code and previous Revenue Acts have permitted taxpayers to claim deductions in computing their income for accounts that become worthless. Two systems or methods are permitted in determining the amount of such deductions. One system is the direct charge-off method which, . . . required a taxpayer to ascertain which of his accounts receivable were, in fact, worthless, and, specifically, to charge them off during the year when they become so. Under the reserve system of claiming deductions for worthless accounts, a taxpayer is permitted to estimate what percentage of his total accounts receivable would become worthless; to set up a reserve to cover such accounts; and to deduct each year the net addition to the reserve which is necessary in order to maintain it at an adequate level to cover those

to consider the question of whether the amount of the reserve for bad debts must be taken into the income of the transferee upon a transfer under Section 351. *Estate of Schmidt* v. *Commissioner,* 355 F.2d 111 (9th Cir. 1966), rev'g. 42 T.C. 1130 (1964). The court found for the taxpayer, reversing the Tax Court. The Ninth Circuit considered it remarkable that no reported case had been found prior to the one under their consideration in which the Commissioner had taken his position. The court stated: "Yet there must have been literally thousands of businesses transferred by taxpayers to corporations in exchange for stock in which the transferring taxpayer used the reserve method of accounting for bad debts. It was not until the revenue ruling that we have quoted that the Commissioner took a published position on the question."[16] The government in their response to our petition recognized that "the incorporation of a proprietorship or partnership is a commonplace transaction" and that "the question presented is a recurring one in the administration of the Code. . . ."

The published position of the Commissioner, in Revenue Ruling 62-128, provides:

> A taxpayer, engaged in a business as a sole proprietor, transferred all of the assets of his business, subject to its liabilities, to a corporation controlled by the transferor in a nontaxable exchange under the provisions of section 351 of the Internal Revenue Code of 1954. Prior

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accounts which he expects to become worthless. Under the reserve system, a taxpayer may not be entitled to claim a bad debt deduction every year because of the fact that the amount of his reserve, as it stands at the end of the year, may be adequate to cover all outstanding accounts which reasonably could be expected to become worthless in the light of his recovery experience." see also *Union National Bank of Youngstown* v. *United States,* 237 F.Supp. 753 (D.C. Ohio 1965), for another discussion of the reserve for bad debts.

[16] 355 F.2d 111, 112-113.

to the transfer, the business had, on its books of account, a reserve for bad debts which had been accumulated by additions for which the taxpayer had derived full tax benefits in prior taxable years. *Held,* under these circumstances the reserve for bad debts is not transferable to any other entity. Accordingly, the reserve for bad debts represents ordinary income to the taxpayer for the taxable year during which the transfer of the accounts receivable was made since, during such time, his need for the reserve ceased. See *Geyer, Cornell & Newell, Inc.* v. *Commissioner,* 6 T.C. 96; acquiescence, C.B. 1946-1, 2; Rev. Rul. 57-482, C.B. 1957-2, 49; and *C. Standlee Martin, Inc.* v. *Riddell,* 56-2, U.S.T.C. 9989, 51 A.F.T.R. 1376. Under similar circumstances, a partnership must likewise include such reserve for bad debts in its final return as ordinary income. However, to the extent that the additions to the reserve for bad debts in prior years may not have resulted in tax benefits, they need not be included in the transferors gross income. See *M. & E. Corporation* v. *Commissioner,* 7 T.C. 1276, acquiescence, C.B. 1947-1, 3.[17]

Revenue Ruling 62-128 is incorrect.[18] As we will discuss

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[17] Rev. Rul. 62-128, 1962-2 C.B. 139 (1962).

[18] The Commissioners position has produced a number of critical comments: Arent, *Reallocation of Income and Expenses in Connecnection with Formation and Liquidation of Corporations,* 40 Taxes, December, 1962, p. 995; Hickman, *Incorporation and Capitalization,* 40 Taxes, December, 1962, p. 974; 1966 U. Ill. L.F. 787; 66 Colum. L.Rev. 1186 (1966); Blanc, *The Tax Treatment of Reserves Upon a Change in the Form of Doing Business,* 1967 Tax Inst. 433; 6 San Diego L.Rev. 291 (1969); 53 Minn. L.Rev. 1354 (1969); 1969 Duke L. J. 1294; For a general discussion of this question, see Bonovitz, *Restoration to Income of Bad Debt Reserves,* 44 Taxes, May 1966, p. 300; Stoffel, *Treatment of Reserve Accounts on Incorporation and Liquidation,* N.Y.U. 26th Inst. on Fed. Tax 773 (1968).

in point III of this brief, the amount of the reserve for bad debts represents ordinary income to a taxpayer in the taxable year during which he recovers the amount of the accounts which were thought to be bad, not when the "need for the reserve ceased" though the two can coincide at the same time. However, if we were to assume for the purpose of argument, that the recovery into ordinary income is predicated on the cessation of the taxpayer's need for the reserve, the taxpayer's need continues in a Section 351 transfer.

The Revenue Ruling totally disregards the principle and purpose of Section 351 and the bad debt reserve. The transfer to the taxpayers' corporations was merely a change in the form and not in the substance of the business and was a mere readjustment. Economic realities of the situation reflect a continuing need in the business for the reserve, since the value of the taxpayers' stock and securities is predicated on the value of the receivables on the books and records of the corporations.

When the bad debt reserve is conceded to be reasonable (A. 12), losses in such amount can ultimately be expected to occur. The application of the Revenue Ruling would thus reach for income in circumstances where none has been or ever will be realized, for the reserve will be entirely absorbed as the debts prove uncollectible. This would, in effect, create income to the taxpayer where none would be created if the businesses had continued in partnership form and ultimately charged those accounts which became uncollectible to the reasonable reserve which it maintained.

The result urged by the Government would be paradoxical indeed, for the enactment of a statute designed to avoid the recognition of gain or loss will have the effect of having precipitated income in a situation where no income exists and where, without Section 351, no income would have been recognized. With receivables in the amount of $486,-

853.69 and a reserve in the amount of $73,028.05, the net receivables which the taxpayers' partnership owned prior to incorporation was $413,825.64. Had these receivables been transferred in a taxable transaction, no income would have been realized because a buyer would obviously not pay any more for receivables than their collectible amount of $413,-825.64. It follows that without Section 351 and thus with a taxable exchange, no income, gain or loss, would have been realized to the taxpayers' partnership upon the transfer of its receivables to the transferee corporations for the latters' stock, because the fair market value of the stock received for the receivables was necessarily no more than their net collectible amount. It would be paradoxical indeed if the existence of a statute such as Section 351, which was intended to prevent the recognition of income, would have the effect of causing the recognition of income.

Revenue Ruling 62-128 will, if applied, distort both the income of any partnership or proprietorship making a transfer, and the income of the transferee corporation. If he be correct in Revenue Ruling 62-128, the Commissioner must agree that a transferee corporation would be entitled to establish the reserve for bad debts on its books in the first year and charge the amount thereof against income, since the amount was reasonable but was not carried over. This would work a grave distortion of the income of the transferor and of the transferee. The taxpayer would have income through the recovery of the reserve in the year the transfer is made, even though he may have no other sales or business activity in that year, other than the transfer to the controlled corporation. The taxpayer will be required to restore to income any reserve for debts which have not yet been collected and for which he has received no consideration tantamount to the recovery of the debt. All that taxpayers in Section 351 transactions receive are shares of stock or securities equal in value to the net worth of the

accounts transferred, that, is, the face value less the amount of the reserve for bad debts. But if the Commissioner prevails, the transferee corporation will obtain a basis in the transferred receivables equal to their face value and be permitted to establish its own reserve for bad debts and, thus, obtain a deduction. This deduction by the corporation would have no relationship whatsoever to any income generated by the corporation in the first year and would, thus, greatly distort the corporation's income.[19]

The purpose of the reserve method was to permit the taxpayer to match the expenses against the corresponding income, yet the application of Revenue Ruling 62-128 would disregard this purpose and the economic realities of the reserve method for deducting bad debts.

The Government's position would force reserve method taxpayers to perform artificial pre-incorporation tax planning by withholding from the transfer to controlled corporations, the accounts receivable. Having retained the accounts receivable, they would be free from the Commissioner's attack. These receivables, however, are rightfully and logically part of the transferred business. As an alternative to this method of avoiding the Commissioners position, the taxpayer could make an outright sale of the

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[19] See the discussion of this point by Arent, *Reallocation of Income and Expenses in Connection with Formation and Liquidation of Corporations,* 40 Taxes, December, 1962 p. 998, wherein Mr. Arent says: "The net effect of the ruling is to shift the deduction representing the risk of noncollection from the transferor to the corporation, even though it is the transferor who pays the tax on the accrued income. The corporation can collect the accounts tax-free since it acquired a substituted basis in the accounts equal to their base amount. Thus, Revenue Ruling 62-128 results in allocating to one entity an item of income and to another entity a direct expense of earning that income, a distortion of net income contrary to the purpose of the reserve method of accounting for bad debts."

accounts receivable prior to incorporation at net value to a third party, thereby avoiding any recognition of income upon the transfer of the other assets and the cash funds to the controlled corporation. In any event, the Commissioner's position would most certainly have the effect of taking a simple transaction, and what is merely a change in the form of a business, and transforming it into a highly technical and tax generating transaction, which was not intended by Congress.[20]

II. SINCE THE AMOUNT IN A RESERVE FOR BAD DEBTS IS NOT TAKEN INTO INCOME BY THE TRANSFEROR IN A CORPORATE REORGANIZATION, THE SAME RULE SHOULD APPLY TO A TRANSFER UNDER SECTION 351.

If a corporation using the accrual method of accounting and the reserve method for bad debts transfers its business, including its receivables, to another corporation in a reorganization as defined in Section 368, the Commissioner would not seek to have the transferor recover into its income the amount of the reserve for bad debts. The transferor corporation does not take the reserve into income, and the transferee corporation will merely set up the reserve on its books without taking a current deduction for the reserve. Yet, if the need for the reserve would cease under a Section 351 transaction, why would it not cease under a reorganization type of transaction?

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[20] This would put back into the scheme of our revenue laws the exact problems which the Senate Finance Committee alluded to in their discussion of this tax-free exchange: "The preceding amendments, if adopted, will, by removing a source of grave uncertainty and by eliminating many technical constructions which are economically unsound, not only permit business to go forward with readjustments required by existing conditions, but also will considerably increase the revenue by preventing taxpayers from taking colorable losses in wash sales and other fictitious exchanges. . . ." S.Rep. 275, 67th Cong. 1st Sess. 10 (1921).

It is readily apparent that the Section 351 corporate organization and the reorganization are quite similar in theory and in purpose. Under Section 362, the basis of property received by the acquiring corporation is the same under Section 351 as it is under a reorganization, namely, its basis in the hands of the transferor.[21] Of course, the basis can be increased by any gain recognized to the transferor. However, the Commissioner in the instant case would even seek to classify the income to the taxpayers, if the Commissioner be successful, not as a "gain" to increase basis, but as "income" having no effect on basis, for no "gain" could be recognized under Section 351.

As this Court has pointed out, "The close relationship between Section 112 (b) (5) [351] and the 'reorganization' provision is further evidenced by the fact that they overlap to a degree." *Helvering* v. *Cement Investors, Inc.*, 316 U.S. 527, 534. Both Section 351 and the reorganization provisions came into the law in the 1921 Revenue Act.

The District Court in *Home Savings & Loan Association* v. *United States,* 223 F. Supp. 134, 136 (D.C. Cal. 1963), correctly distinguished the theory behind a merger from that involved in a complete liquidation of a business. The court therein quoted with approval the language of the Court of Claims in *Citizens Federal Savings & Loan Association of Cleveland* v. *United States,* 290 F.2d 932 (Ct. Cl. 1961), distinguishing between a complete liquidation and a reorganization:

> Further, the plaintiff argues for non-recognition [pursuant to Sec. 337] by pointing out that under sections 332(a) and 354(a)(1) of the 1954 Code no gain is recognized on the liquidation of subsidiaries or on stock exchanges in corporate reorganizations. The short an-

[21] §362 is set out in full at p. — in the Appendix.

swer to this, we think, is to emphasize *the clear distinction between a complete liquidation* [pursuant to Sec. 337] on the one hand and *liquidation into a parent corporation* and reorganization of a corporation's capital structure on the other. In the latter situations [sic] *the holder of the asset continues in existence, although in an altered form, and continues to experience the risk of bad debt loss.* Thus, unlike the former situation where the corporation goes out of existence, the reserve does not lose its reason for existence and there is no reason not to accord non-recognition. [Emphasis supplied]

Although this was dictum by the Court of Claims, since they were considering the complete liquidation of a corporation and held that the reserve should be recovered in the income, it does recognize that the holder of the receivables in a reorganization continues in existence in merely an altered form, and "continues to experience the risk of bad debt loss." This should be the same philosophy which applies to the Section 351 transfers where there has been merely a change in form and the controlling stockholder continues to experience the risk of bad debt loss in his corporation.

In *Calavo, Inc.* v. *Commissioner,* 304 F.2d 650 (9th Cir. 1963), which also involved a Section 332 merger, the Commissioner initially sought to have the amount of the reserve included in the final return of the transferor. But before the Tax Court, he conceded that this was error and that the bad debt reserve was not to be restored to the income of Calavo, Inc., the transferor corporation.[22]

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[22] The Tax Court, in the *Estate of Heinz Schmidt,* 42 T.C. 1130, 1136 ftn. 7, stated: "The dictum in the *Citizens Federal* case was followed in *Home Savings & Loan Association* v. *United States,* 223 F.Supp. 134 (D.C. Cal.), and the reason for the Government's failure to pursue an appeal therein has not been disclosed. Similarly, there has

The Tax Court was the first court to consider the problem of the reserve for bad debts in connection with a transfer under Section 351 solely in exchange for stock and securities. *Estate of Heinz Schmidt,* 42 T.C. 1130 (1964), rev'd. 355 F.2d 111 (9th Cir. 1966). The taxpayer, before the Tax Court, had urged that the reserve not be taken into his income in the year of incorporation. The corporation to which the transfer had been made had established a reserve in a like amount, without taking any deduction against its income for the reserve. The taxpayer therein urged, as we similarly urge here, that since the reserve is reasonable, the projected amount of bad accounts will ultimately materialize. The balance in the reserve would be absorbed by the accounts actually charged off by the corporation. If a reserve be incorrect, at the time all of the receivables are collected in, any remaining amount would then be included in the income of the corporation, having been recovered. Judge Raum, in expressing the opinion of the Tax Court, said: "Such result would appear to be desirable, though we are dealing with a statute characterized by a high degree of specificity, and we must take it as we find it." (p. 1136). The Tax Court felt that without a carryover provision specifically set out in the statute they could not reach this desirable result.[23]

In the more recent Tax Court case of *Max Schuster,* 50 T.C. 98 (1968), the court again decided the identical issue before this Court adversely to the taxpayer, relying on the

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been no explanation of the Government's position in *Calavo, Inc.* v. *Commissioner,* 304 F.2d 650, 652 (C.A. 9), reversing on other grounds a memorandum opinion of this Court."

[23] The Tax Court relied on Rev. Ruling 62-128 and its decision in *West Seattle National Bank of Seattle,* 33 T.C. 341, aff'd. 288 F.2d 47 (9th Cir. 1961), a case dealing with a 337 liquidation. The 9th Circuit effectively distinguished the *West Seattle* case decided by them in their reversal of the *Estate of Schmidt,* 355 F.2d 111, 114 (1966).

same authorities as it had cited in the *Schmidt* case. Judge Raum, writing for the Tax Court, again stated: "The Code is a highly complex instrument, and it would be inappropriate, *in order to reach a seemingly equitable result,* to proceed upon theories that depart from an established course of decision or that do violence to the statute . . . ." (p. 102). [Emphasis Supplied]

We would all apparently agree that a rule which would provide no income at the time of incorporation and allowed the reserve to be carried over to the corporation would be the most desirable. We disagree, of course, as to whether it can be reached.[24] We maintain that the lack of specific statutory direction for the carry-over does not obviate the intent, purpose and scope of Section 351.

The logical answer, of course, is that the reserve would be carried over and established by the corporation without the corporation taking a new deduction. This is exactly what took place in the taxpayers' case, in the *Schmidt* case, in the *Schuster* case, and in the other recently reported cases concerning a 351 transaction.[25] In fact, no case can be found which indicates that any corporation in a 351 transaction involving a reserve for bad debts has done other than to merely carry the reserve over without taking or attempting to take any new deduction for the reserve.

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[24] The Fifth Circuit in the decision upon review may have indicated they do not agree that this would be an equitable result. The Court, in their next to the last paragraph in the opinion (A. 15) seems to emphasize the difference in rates which would exist between individual transferors and corporations. Needless to say, this would be a tenuous basis for deciding the correct rule of law. The tax brackets of transferors and transferees may be the same or more or less in reorganizations and in Section 351 transfers.

[25] *Rowe, et al* v. *United States,* 69-1 U.S.T.C. ¶9162 (D.C. Ky.); *Hutton* v. *Commissioner,* 53 T.C.—No. 6 (1969); and *Scofield* v. *United States,* 69-1 U.S.T.C. ¶9386 (D.C. Cal.).

The Commissioner should not contend that the presence of Section 381 in the Internal Revenue Code should distinguish the reorganization situation from the 351 situation. Section 381 was originally enacted in the 1954 Code. (68 Stat. 124.) The only portion of Section 381 which could be pertinent generally requires the acquiring corporation to use the method of accounting used by the transferor corporation.[26]

The Commissioner would seem to have ample authority to require the corporation in a Section 351 transfer to continue the reserve method if that be the key to the Commissioner's apparent dilemma in this situation. Treasury Regulation, Section 1.166-1(b)(1) provides:

> (a) A taxpayer filing a return of income for the first taxable year for which he is entitled to a bad debt deduction may select either of the two methods prescribed by paragraph (a) of this section for treating bad debts [either a deduction when the debt becomes worthless or a deduction for a reasonable addition to a reserve] *but such selection is subject to the approval of the District Director upon examination of the return.* [Emphasis supplied]

This section 381 was not relied on in *Home Savings & Loan Association,* 223 F.Supp. 134 (D.C. Cal. 1963), dealing with the merger of the subsidiary into the parent corporation or in the dictum expressed by the Court of Claims in *Citizens Federal Savings & Loan Association of Cleveland,* 290 F.2d 932 (Ct.Cl. 1961). In addition, Treasury Regulation Section 1.381(c)(4)-1 was finally adopted in 1964, subsequent to these decisions.

While Congress, in Section 381, may not have specifically provided for the carry-over of bad debt reserves in the

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[26] Section 381(c)(4) is set out in the Appendix to this brief at p. 40.

case of Section 351 transactions, this does not mean that Congress sought to prevent a carry-over of the reserve in a §351 transaction. On the contrary, the Congressional history behind §381, and prior judicial authority, lead to the opposite conclusion.

The Senate Committee Reports contain the following statement:

> "Present practice rests on court-made law which is uncertain and frequently contradictory. Your committee agrees that whether or not the items carryover should be based upon economic realities rather than upon such artificialities as the legal form of the reorganization." S.Rep. No. 1622, 83rd Cong. 2d Sess. 52 (1954).

There were no uncertainties in a Section 351 transfer as evidenced by the complete lack of any cases or revenue rulings on the question presented to this court prior to Revenue Ruling 62-128, 1962-2 C.B. 139 (1962) and *Estate of Schmidt,* 42 T.C. 1130, rev'd. 355 F.2d 111 (9th Cir. 1966).

Furthermore, in enacting §381 in the 1954 Code, Congress made it quite clear that §381 dealt only with certain corporate readjustments in the carry-over of specific attributes enumerated therein and that transactions and attributes outside the narrow confines of §381 were not to be affected by the enactment of §381. The following is a statement from the Committee Reports:

> Subsection (c) of this section contains 18 paragraphs, each of which specifies an item or tax attribute of distributor or transferor corporation which is to be taken into account by the acquiring corporation as of the close of the date of distribution or transfer in the manner and to the extent provided with respect to such item. *This section is not intended to affect the carry-*

over treatment of items or tax attributes not specified in the section or the carry-over treatment of items or tax attributes in corporate transactions not described in subsection (a). No inference is to be drawn from the enactment of this section whether any item or tax attribute may be utilized by a successor or a predecessor corporation under existing law. (S. Rep. No. 1622, 83rd Cong. 2nd Sess. 275 (1954).) [Emphasis supplied.]

Even the Commissioner's own regulation, §1.381(a)-1 (b)(3) provides that in situations where §381 does not apply, no inference is to be drawn from §381 as to whether any item or tax attribute is to be carried over.

Prior to the enactment of §381, and without any specific statutory authority, the courts have permitted the carry-over of certain tax items. In *Helvering* v. *Metropolitan Edison Co.,* 306 U.S. 522 (1939), and in *Newmarket Manufacturing Co.* v. *United States,* 233 F.2d 492 (1st Cir. 1956), it was held that in a merger the transferee corporation could carry over the net operating loss of the predecessor corporation.[27] Judge Simpson, in his dissent, in *Max Schuster,* 50 T.C. 98, 103 (1968) considered that the lack of specific statutory authority should not preclude the court from allowing a carry-over of the bad debt reserve because of the judicial history and the theory behind Section 381. This would be the result we would urge the Court to follow.[28]

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[27] See also *Commissioner* v. *Sansome,* 60 F.2d 931 (2nd Cir. 1932), which involved the carry-over of a corporation's earnings and profits.

[28] Judge Simpson stated, in part:

"The majority considers that the lack of a specific statutory authorization precludes us from allowing a carryover of the bad debt reserve in a §351 transfer. However, without specific statutory authority, the carryover of tax attributes from one legal person to another in some cases was allowed prior to the enactment of §381. Helvering v. Metropolitan Edison Co., 306 U.S. 522 [22 AFTR 307]

The Commissioner has provided in his Treasury Regulations under Section 381 that an acquiring corporation, in a transaction covered by Section 381, shall take into account the dollar balances of accounts which represent reserves for prior years.[29] This would provide for the carry-over in the Commissioner's view of the bad debt reserve. This Section construes Section 381(c)(4) of the Internal Revenue Code where Congress provided for the method of accounting to be carried over. The legislative history does not define "method of accounting" to include the reserve method of deducting bad debts. The Commissioner, in Treasury Regulation Section 1.446-1(a)(1) dealing with methods of accounting, does not mention the reserve method as being a "method of accounting." In addition, the statutory reference to the carry-over method does not deny a new deduction. It can only be concluded that the Commissioner, in promul-

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(1939); Commissioner v. Sansome, 60 F.2d 931 [11 AFTR 857] (C.A. 2, 1932). Moreover, although §381 contains extensive rules regarding carryovers in some transactions, Congress made clear that §381 was not to be exclusive. S. Rep. No. 1622, 83rd Cong., 2d Sess., pp. 276-277 (1954), and H. Rept. No. 1337, 83d Cong., 2d Sess., p. A135 (1954), to accompany H.R. 8300 (Pub. L. 591). See also §1.381(a)-1(b)(3), Income Tax Regs. In addition, without specific statutory authorization, the regulations provide that the transfer of an installment obligation in a transaction under §351 is not a disposition of the obligation for purposes of §453(d). Sec. 1.453-9(c)(2).

To avoid distorting the income of the business and to carry out the purpose of §351, I would hold that the transferor's unused bad debt reserve is carried over to the transferee corporation. As a result, the transferor would not be taxed on the unused reserve, and the transferee would not be allowed a deduction for building up a reserve. The transferee would stand in the shoes of the transferor so that the corporation would be required to continue to use the reserve method for treating bad debts, unless it secured the approval of the Commissioner to change such method."

[29] Treas. Reg. §1.381(c)(4)-1(a)(1)(ii).

gating his regulations, felt that the reserve for bad debts should be carried over and not restored to income where there was a mere change in the form of a business, such as in the liquidation of a subsidiary, or a reorganization. These transactions are very similar to Section 351 exchanges, in that there is simply a change in the *form* of doing business.

The Commissioner should not be apprehensive about a corporation trying to take advantage of the Section 351 transfer involving a reserve for bad debts for the Commissioner has not only his regulations previously referred to under Section 166, but also has other weapons in his armory. If the corporation were to attempt to select a direct charge-off method and establish a basis for the receivables at their face instead of net value, the Commissioner could come forward with Section 446 asserting that either the new corporation's method does not clearly reflect income, or that the old partnership or proprietorship method did not clearly reflect income. See *Commissioner* v. *Kuckenberg,* 309 F.2d 202 (9th Cir. 1960); cert. den'd. 373 U.S. 909 (1963) (involving the reallocation of income to a corporation). Or the Commissioner could utilize Section 482 providing for allocation of income and expenses among two controlled businesses in order to prevent evasion of taxes or clearly reflect the income of any such businesses. See *Rooney* v. *United States,* 305 F.2d 681 (9th Cir. 1962) (reallocation to corporation of expenses incurred by an individual prior to a Section 351 transfer).[30]

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[30] See also *Palmer* v. *Commissioner,* 267 F.2d 434 (9th Cir. 1959) (Earnings adjusted between corporation and partnership based on assignment of income); *United States* v. *Lynch,* 192 F.2d 718 (9th Cir. 1951); cert. den. 343 U.S. 934 (income deemed earned by the corporation and the power of Commissioner to require method of accounting which would clearly reflect income, §446); *National Securities Corporation* v. *Commissioner,* 137 F.2d 600 (3rd Cir. 1942)

Possibly, the simplest approach is to recognize that the reserve for bad debts reduces the basis for the receivables to the partnership and, thus, to the transferee corporation much in the same fashion that a reserve for depreciation functions. Depreciation is regarded as an adjustment to basis under Section 1016(a)(2) and the bad debt reserve additions could be regarded as similar adjustments to basis under Section 1016(a)(1). The Commissioner does not contend that depreciation adjustments give rise to taxable income upon the creation of a corporation under Section 351. This is true even under the stringent requirements of the relatively new depreciation recapture rules of Section 1245(b)(3) and 1250(b)(3). Section 1016(a)(1) requires adjustment for "expenditures, receipts, losses or other items properly chargeable to capital account." Section 1011, which determines bases of assets, provides for adjustments as provided in Section 1016. The Commissioner would contend that the additions to reserves are not adjustments, but would agree that direct charge-offs under the alternate method provided for bad debts would be. It would seem only proper, however, that the taxpayer who elects the reserve method of accounting for bad debts should not be treated differently from one who uses the direct charge-off method, and that both should adjust the basis of the accounts receivable when either the debt is charged off or the addition to the reserve is made. Having an adjusted basis, the receivables would then go over to the corporation, at their adjusted basis, and there would be no possible way for the corporation to secure any second deduction since it would be

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(allocation of loss between two businesses based on power given Commissioner under predecessor of §482 and §45, Rev. Act 1936); *Central Cuba Sugar Co.* v. *Commissioner,* 198 F.2d 214 (2nd Cir. 1952), cert. den'd. 344 U.S. 874 (1952) (income required to be recognized by corporation in order to clearly reflect income).

dealing with receivables which had a basis equal to the net value to the transferor. Section 362(a) requires both in a reorganization and a 351 transfer, that the controlled corporations carry over and retain the bases for transferred property in the hands of the transferor.

Congress has treated Section 351 transfers and reorganizations in a similar fashion from their inception in 1921 to the present time.[31] Section 381 was not deemed to be exclusive, and was put in the Code, frankly, when no one was aware that a problem existed in this area under Section 351. Since these two reorganizations of businesses are so similar in theory and in concept, there should be no disparity in the treatment by the Commissioner of the reserve for bad debts of a transferor who participates in either one or the other form of business adjustments.

III. THE AMOUNT IN THE RESERVE FOR BAD DEBTS SHOULD BE RESTORED TO TAXABLE INCOME, PROVIDED ADDITIONS THERETO HAVE RESULTED IN TAX BENEFITS, WHEN THERE IS A RECOVERY.

The Commissioner is incorrect in his statement in Revenue Ruling 62-128, that the reserve represents ordinary income when the need for the reserve ceases. The cases relied on by the Commissioner in propounding the rule do not go that far.[32] We have never agreed that the presence of need is the determing factor as indicated by the court

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[31] See similar treatment under the recapture rules of Sections 47(b), 1245(b)(3), and 1250(d)(3) of the Code.

[32] See a discussion of this point in *Estate of Schmidt* v. *Commissioner,* 355 F.2d 111, 113 (1966). In Footnote 7, the Ninth Circuit states:

"In Geyer, Cornell & Newell, Inc., 1946, 6 T.C. 96, the amount of the reserve was actually collected. This is equally true of West Seattle Nat'l. Bank, *supra,* and of the other cases upon which the Commissioner principally relies: S. Rossin & Sons, Inc. v. Commissioner,

below, but have continued to insist throughout this litigation that there must be recovery before the reserve is taken into income. The Fifth Circuit stated that this lack of need generally occurred upon final liquidation or upon sale of the assets in a manner that demonstrates that they are worth face value. (A. 15). We submit it is not the lack of need which occurs at this point, but a recovery and that this is the basis for taking the reserve into income.

The Commissioner in Revenue Ruling 62-128 cited as authority *Geyer, Cornell and Newell, Inc.* v. *Commissioner*, 6 T.C. 96 (1946). In this case, the Commissioner had urged that a reserve for bad debts became taxable income to a corporation when it transferred its assets to another corporation in exchange for certain stock. The taxpayer therein urged the reserve should have been picked up in an earlier year at a time all of his receivables had been paid in full. The Court held in favor of the taxpayer. The Commissioner also cited *C. Standlee Martin, Inc.* v. *Riddell*, 56-2 U.S.T.C. ¶9989, 51 AFTR 1376 (D.C.Cal. 1956). This was a District Court case involving a memorandum opinion considering the effects of a complete liquidation of a corpo-

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2 Cir., 1940, 113 F.2d 652, 654; Citizens Fed. Sav. & Loan Co. v. United States, 1961, 290 F.2d 932, 936, 154 Ct. Cl. 305; Arcadia Sav. & Loan Ass'n. v. Commissioner, 9 Cir., 1962, 300 F.2d 247. The lack of 'need' for the reserve arose from collection (or sale) of the receivables. And, as is illustrated by the foregoing cases, it is generally only to the extent that what is collected represents the reserve, or a part of it, that income is said to be realized. There may be cases, such as a change in accounting methods, where the 'realization' is technical rather than actual (see Arcadia, supra, at p. 250), but we think that this case is not one of them."

ration. The Commissioner also cited as authority his Revenue Ruling 57-482, 1957-2 C. B. 49.[33]

That there must be a recovery before income results was the basis of the Ninth Circuit's opinion in the *Schmidt* case, reversing the Tax Court. 355 F.2d 111 (1966).

Since the reserve was deemed to be reasonable, the value of the stock received upon the transfer was equal to the net value of the receivables and, therefore, there was not any "recovery." The court said: "We think that, whether the sale be for cash or stock, no income is received, unless the consideration received exceeds the net amount of the receivables. . . We think that where accounts receivable are sold for cash for less than face value, the difference being the amount of the reserve, the taxpayer does not then 'realize a loss.' He 'realized' the loss for tax purposes, when he set up the reserve, and cannot have it twice. The price received merely demonstrates that the estimate of the loss was correct." (p. 114)

The Commissioner seemed to recognize the need for a recovery in Revenue Ruling 57-482, 1957-2 C.B. 49, wherein it was held that the bad debt reserve must be restored to

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[33] Rev. Rul. 57-482 is set forth in full in Appendix at p 49. It is interesting to note the Revenue Ruling cites as authority only the *Geyer* case, *supra.* The Tax Court in §337 liquidations has required the reserve to be recovered by the liquidating corporation. *Byrd Management, Inc.,* 48 T.C. 586 (1967); *J. E. Hawes Corp.,* 44 T.C. 705 (1965). However, in each of these cases, the evidence does not show the receivables to be worth less than face value. Of course, the statutory purpose of §337 is quite different from §351. See S. Rep. 1622, 83rd Cong. 2d Sess., 258 (1954). This provision was introduced in the 1954 Code to avoid taxation on both the corporation and the stockholder on the same transaction, and eliminate the problem of whether a sale had been made by the corporation before liquidation or by the stockholders after liquidation.

income in a Section 337 liquidation, where there has been a sale of accounts receivable for their "face value."

In Revenue Ruling 62-128, the Commissioner further provided that additions to the reserve for bad debts which had not resulted in tax benefits would not have to be included in gross income. This is essentially the same rule as promulgated by Section 111 pursuant to which a taxpayer using the direct charge-off method, must, upon recovery of a debt, restore the amount of the debt to income to the extent of the tax benefits afforded him in prior years by the charge-off.[34] The Commissioner provides very comprehensive regulations under this section, and sets forth therein the following definition of the term "recovery": "Recoveries result from the receipt of amounts in respect of the previously deducted or credited Section 111 items, such as from the collection or sale of a bad debt, refund or credit of tax paid, or cancellation of taxes accrued. . . ."[35]

While the Commissioner apparently adheres to the theory that the tax benefit rule applies in Section 351 situations as illustrated by Revenue Ruling 62-128, he fails to correctly follow this theory to its conclusion. Although Section 111 is not applicable to the taxpayer on the reserve method, the basic equitable philosophy expressed therein should be judicially impressed on the reserve for bad debts.[36] Upon the transfer of notes and accounts receivables to a corporation in exchange for stock and securities representing the net value of the receivables, there is no "recovery" of the reserve for bad debts. In a Section 351 transaction, there is no collection or recovery of a bad debt, but merely an adjustment in the form in which the business is carried on.

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[34] The pertinent portions of Section 111 are set forth in Appendix at p. —.

[35] Treas. Reg. §1.111-1(a)(2).

[36] H. Rep. 2333, 77th Cong., 2nd Sess. 69-71 (1942).

CONCLUSION

The judgment of the Court of Appeals should be reversed and the decision of the District Court ordered affirmed.

Respectfully submitted,

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DATED: FEBRUARY 1970.

APPENDIX

Statutes, Regulations, and Ruling Involved

Internal Revenue Code of 1954:

SEC. 111. RECOVERY OF BAD DEBTS, PRIOR TAXES, AND DELINQUENCY AMOUNTS.

(a) General Rule.—Gross income does not include income attributable to the recovery during the taxable year of a bad debt, prior tax, or delinquency amount, to the extent of the amount of the recovery exclusion with respect to such debt, tax, or amount.

(b) Definitions.—For purposes of subsection (a)—

(1) Bad Debt.—The term "bad debt" means a debt on account of the worthlessness or partial worthlessness of which a deduction was allowed for a prior taxable year.

(2) Prior Tax.—The term "prior tax" means a tax on account of which a deduction or credit was allowed for a prior taxable year.

(3) Delinquency Amount.—The term "delinquency amount" means an amount paid or accrued on account of which a deduction or credit was allowed for a prior taxable year and which is attributable to failure to file return with respect to a tax, or pay a tax, within the time required by the law under which the tax is imposed, or to failure to file return with respect to a tax or pay a tax.

(4) Recovery Exclusion.—The term "recovery exclusion," with respect to a bad debt, prior tax, or delinquency amount, means the amount, determined in accordance with regulations prescribed by the Secretary or his delegate, of the deductions or credits allowed, on account of such bad debt, prior tax, or delinquency amount, which did not result in a reduction of the taxpayer's tax under this subtitle (not including the accumulated earnings tax imposed by

section 531 or the tax on personal holding companies imposed by section 541) or corresponding provisions of prior income tax laws (other than subchapter E of chapter 2 of the Internal Revenue Code of 1939, relating to World War II excess profits tax), reduced by the amount excludable in previous taxable years with respect to such debt, tax, or amount under this section.

* * * *

[26 U.S.C. Sec. 111.]

SEC. 166. BAD DEBTS.

(a) General Rule.—

(1) Wholly Worthless Debts.—There shall be allowed as a deduction any debt which becomes worthless within the taxable year.

(2) Partially Worthless Debts.—When satisfied that a debt is recoverable only in part, the Secretary or his delegate may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction.

(b) Amount of Deduction.—For purposes of subsection (a), the basis for determining the amount of the deduction for any bad debt shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

(c) Reserve for Bad Debts.—In lieu of any deduction under subsection (a), there shall be allowed (in the discretion of the Secretary or his delegate) a deduction for a reasonable addition to a reserve for bad debts.

* * * *

[26 U.S.C. Sec. 166.]

SEC. 337. GAIN OR LOSS ON SALES OR EXCHANGES IN CONNECTION WITH CERTAIN LIQUIDATIONS.

(a) General Rule.—If—

(1) a corporation adopts a plan of complete liquidation on or after June 22, 1954, and

(2) within the 12-month period beginning on the date of the adoption of such plan, all of the assets of the corporation are distributed in complete liquidation, less assets retained to meet claims,

then no gain or loss shall be recognized to such corporation from the sale or exchange by it of property within such 12-month period.

* * * *

[26 U.S.C. Sec. 337.]

SEC. 351. TRANSFER TO CORPORATION CONTROLLED BY TRANSFEROR.

(a) General Rule.—No gain or loss shall be recognized if property is transferred to a corporation (including, in the case of transfers made on or before June 30, 1967, an investment company) by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation. For purposes of this section, stock or securities issued for services shall not be considered as issued in return for property.

(b) Receipt of Property.—If subsection (a) would apply to an exchange but for the fact that there is received, in addition to the stock or securities permitted to be received under subsection (a), other property or money, then—

(1) gain (if any) to such recipient shall be recognized, but not in excess of—

(A) the amount of money received, plus

(B) the fair market value of such other property received; and

(2) no loss to such recipient shall be recognized.

(c) Special Rule.—In determining control, for purposes of this section, the fact that any corporate transferor distributes part or all of the stock which it receives in the ex-

change to its shareholders shall not be taken into account.

* * * *

[26 U.S.C. Sec. 351.]

SEC. 362. BASIS TO CORPORATIONS

(a) Property Acquired by Issuance of Stock or as Paid-In Surplus.—If property was acquired on or after June 22, 1954, by a corporation—

(1) in connection with a transaction to which section 351 (relating to transfer of property to corporation controlled by transferor) applies, or

(2) as paid-in surplus or as a contribution to capital,

then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer.

(b) Transfers to Corporations.—If property was acquired by a corporation in connection with a reorganization to which this part applies, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer. This subsection shall not apply if the property acquired consists of stock or securities in a corporation a party to the reorganization, unless acquired by the exchange of stock or securities of the transferee (or of a corporation which is in control of the transferee) as the consideration in whole or in part for the transfer.

* * * *

[26 U.S.C. Sec. 362.]

SEC. 381. CARRYOVERS IN CERTAIN CORPORATE ACQUISITIONS

(a) General Rule.—In the case of the acquisition of assets of a corporation by another corporation—

(1) in a distribution to such other corporation to which section 332 (relating to liquidations of subsidiaries) applies, except in a case in which the basis of the assets distributed is determined under section 334(b)(2); or

(2) in a transfer to which section 361 (relating to nonrecognition of gain or loss to corporations) applies, but only if the transfer is in connection with a reorganization described in subparagraph (A), (C), (D) (but only if the requirements of subparagraph (A) and (B) of section 354(b)(1) are met), or (F) of section 368(a)(1),

the acquiring corporation shall succeed to and take into account, as of the close of the day of distribution or transfer, the items described in subsection (c) of the distributor or transferor corporation, subject to the conditions and limitations specified in subsections (b) and (c).

* * * *

(c) Items of the Distributor or Transferor Corporation. —The items referred to in subsection (a) are:

* * * *

(4) Method of Accounting.—The acquiring corporation shall use the method of accounting used by the distributor or transferor corporation on the date of distribution or transfer unless different methods were used by several distributor or transferor corporations or by a distributor or transferor corporation and the acquiring corporation. If different methods were used, the acquiring corporation shall use the method or combination of methods of computing taxable income adopted pursuant to regulations prescribed by the Secretary or his delegate.

* * * *

[26 U.S.C. Sec. 381.]

SEC. 446. GENERAL RULE FOR METHODS OF ACCOUNTING.

(a) General Rule.—Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

(b) Exceptions.—If no method of accounting has been regularly used by the taxpayer, or if the method used does

not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income.

[Sec. 446 (c)]

(c) Permissible Methods.—Subject to the provisions of subsections (a) and (b), a taxpayer may compute taxable income under any of the following methods of accounting—

(1) the cash receipts and disbursements method;

(2) an accrual method;

(3) any other method permitted by this chapter; or

(4) any combination of the foregoing methods permitted under regulations prescribed by the Secretary or his delegate.

(d) Taxpayer Engaged in More Than One Business.—A taxpayer engaged in more than one trade or business may, in computing taxable income, use a different method of accounting for each trade or business.

[Sec. 446 (e)]

(e) Requirement Respecting Change of Accounting Method.—Except as otherwise expressly provided in this chapter, a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Secretary or his delegate.

[26 U.S.C. Sec. 446.]

SEC. 482. ALLOCATION OF INCOME AND DEDUCTIONS AMONG TAXPAYERS.

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or

allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

[26 U.S.C. Sec. 482.]

SEC. 1016. ADJUSTMENTS TO BASIS.

(a) General Rule.—Proper adjustment in respect of the property shall in all cases be made—

(1) for expenditures, receipts, losses, or other items, properly chargeable to capital account, but no such adjustment shall be made—

(A) for taxes or other carrying charges described in section 266, or

(B) for expenditures described in section 173 (relating to circulation expenditures),

for which deductions have been taken by the taxpayer in determining taxable income for the taxable year or prior taxable years;

(2) in respect of any period since February 28, 1913. for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent of the amount—

(A) allowed as deductions in computing taxable income under this subtitle or prior income tax laws, and

(B) resulting (by reason of the deductions so allowed) in a reduction for any taxable year of the taxpayer's taxes under this subtitle (other than chapter 2, relating to tax on self-employment income), or prior income, war-profits, or excess-profits tax laws. . . .

* * * *

[26 U.S.C. Sec. 1016.]

Revenue Act of 1921:

SEC. 202. BASIS FOR DETERMINING GAIN OR LOSS.

* * * *

(c) For the purposes of this title, on an exchange of property, real, personal or mixed, for any other such property, no gain or loss shall be recognized unless the property received in exchange has a readily realizable market value; but even if the property received in exchange has a readily realizable market value, no gain or loss shall be recognized—

(1) When any such property held for productive use in trade or business (not including stock-in-trade or other property held primarily for sale), is exchanged for property of a like kind or use;

(2) When in the reorganization of one or more corporations a person receives in place of any stock or securities owned by him, stock or securities in a corporation a party to or resulting from such reorganization. The word "reorganization," as used in this paragraph, includes a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or of substantially all the properties of another corporation), recapitalization, or mere change in identity, form, or place of organization of a corporation, (however effected); or

(3) When (A) a person transfers any property, real, personal or mixed, to a corporation, and immediately after the transfer is in control of such corporation, or (B) two or more persons transfer any such property to a corporation, and immediately after the transfer are in control of such corporation, and the amounts of stock, securities, or both, received by such persons are in substantially the same proportion as their interests in the property before such transfer. For the purposes of this paragraph, a person is, or two or more persons are, "in control" of a corporation when owning at least 80 per centum of the voting stock and at least 80 per centum of

the total number of shares of all other classes of stock of the corporation.

Treasury Regulations (1954 Code):

§1.166-1. Bad Debts.—

(a) Allowance of Deduction.—Section 166 provides that, in computing taxable income under section 63, a deduction shall be allowed in respect of bad debts owed to the taxpayer. For this purpose, bad debts shall, subject to the provisions of section 166 and the regulations thereunder, be taken into account either as—

(1) A deduction in respect of debts which become worthless in whole or in part; or as

(2) A deduction for a reasonable addition to a reserve for bad debts.

(b) Manner of Selecting Method.—(1) A taxpayer filing a return of income for the first taxable year for which he is entitled to a bad debt deduction may select either of the two methods prescribed by paragraph (a) of this section for treating bad debts, but such selection is subject to the approval of the district director upon examination of the return. If the method so selected is approved, it shall be used in returns for all subsequent taxable years unless the Commissioner grants permission to use the other method. A statement of facts substantiating any deduction claimed under section 166 on account of bad debts shall accompany each return of income.

* * * *

[26 C. F. R. 1.166-1.]

§1.166-4. Reserve for Bad Debts.—

(a) Allowance of Deduction.—A taxpayer who has established the reserve method of treating bad debts and has maintained proper reserve accounts for bad debts or who, in accordance with paragraph (b) of §1.166-1, adopts the reserve method of treating bad debts may deduct from gross

income a reasonable addition to a reserve for bad debts in lieu of deducting specific bad debt items.

(b) Reasonableness of Addition to Reserve.—

(1) Relevant factors. What constitutes a reasonable addition to a reserve for bad debts shall be determined in the light of the facts existing at the close of the taxable year of the proposed addition. The reasonableness of the addition will vary as between classes of business and with conditions of business prosperity. It will depend primarily upon the total amount of debts outstanding as of the close of the taxable year, including those arising currently as well as those arising in prior taxable years, and the total amount of the existing reserve.

(2) Correction of Errors in Prior Estimates. In the event that subsequent realizations upon outstanding debts prove to be more or less than estimated at the time of the creation of the existing reserve, the amount of the excess or inadequacy in the existing reserve shall be reflected in the determination of the reasonable addition necessary in the current taxable year.

* * * *

[26 C.F.R. 1.166-4.]

§1.351-1. Transfer to Corporation Controlled by Transferor.—

(a)(1) Section 351(a) provides, in general, for the nonrecognition of gain or loss upon the transfer by one or more persons of property to a corporation solely in exchange for stock or securities in such corporation if, immediately after the exchange, such person or persons are in control of the corporation to which the property was transferred. As used in section 351, the phrase "one or more persons" includes individuals, trusts, estates, partnerships, associations, companies, or corporations (see section 7701(a)(1)). To be in control of the transferee corporation, such person or per-

sons must own immediately after the transfer stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of such corporation (see section 368(c)). In determining control under this section, the fact that any corporate transferor distributes part or all of the stock which it receives in the exchange to its shareholders shall not be taken into account. The phrase "immediately after the exchange" does not necessarily require simultaneous exchanges by two or more persons, but comprehends a situation where the rights of the parties have been previously defined and the execution of the agreement proceeds with an expedition consistent with orderly procedure. For purposes of this section—

(i) stock or securities issued for services rendered or to be rendered to or for the benefit of the issuing corporation will not be treated as having been issued in return for property, and

(ii) stock or securities issued for property which is of relatively small value in comparison to the value of the stock and securities already owned (or to be received for services) by the person who transferred such property, shall not be treated as having been issued in return for property if the primary purpose of the transfer is to qualify under this section the exchanges of property by other persons transferring property.

For the purpose of section 351, stock rights or stock warrants are not included in the term "stock or securities."

* * * *

[26 C.F.R. 1.351-1.]

§1.362-1. Basis to Corporations.—Section 362 provides, as a general rule, that if property was acquired on or after June 22, 1954, by a corporation in connection with (a) a transaction to which section 351 (relating to transfer of

property to corporation controlled by transferor) applies, (b) as paid-in surplus or as a contribution to capital, or (c) in connection with a reorganization to which Part III, subchapter C, chapter 1 of the Code, applies, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer. Section 362 does not apply if the property acquired consists of stock or securities in a corporation a party to the reorganzation, unless acquired by the issuance of stock or securities of the transferee as the consideration in whole or in part for the transfer. (See also §1.362-2.) [Reg. §1.362-1.]

* * * *

[26 C.F.R. 1.362-1.]

§1.381 (a)—1. Carryovers in Certain Corporate Acquisitions.

* * * *

§1.381(c)(4)-1. Method of Accounting.—(a) Carryover Requirement.—(1) General Rule. (i) Section 381(c)(4) provides that, in a transaction to which section 381(a) applies, an acquiring corporation shall use the same method of accounting used by the distributor or transferor corporation on the date of distribution or transfer unless different methods of accounting were used on that date by several distributor or transferor corporations or by a distributor or transferor corporation and the acquiring corporation. If different methods of accounting were used, the acquiring corporation shall use the method or combination of methods of accounting adopted pursuant to this section.

(ii) The acquiring corporation shall take into its accounts the dollar balances of those accounts of the distributor or transferor corporation representing items of income or deduction which, because of its method of accounting, were not required or permitted to be included or de-

ducted by the distributor or transferor corporation in computing taxable income for taxable years ending on or before the date of distribution or transfer. The acquiring corporation shall similarly take into its accounts the dollar balances of those accounts of the distributor or transferor corporation which represent reserves in respect of which the distributor or transferor corporation has taken a deduction for taxable years ending on or before the date of distribution or transfer. Items of income and deduction shall have the same character in the hands of the acquiring corporation as they would have had in the hands of the distributor or transferor corporation or corporations if no distribution or transfer had occurred. This section shall have no application to items of income or deduction, or dollar balances, to the extent they are attributable to assets or liabilities not distributed or transferred, and shall have no application to items the tax treatment of which is specifically provided for in other paragraphs of section 381(c). In the case of an obligation of the distributor or transferor corporation which is assumed by the acquiring corporation and which gives rise to a liability (within the meaning of paragraph (a)(4) of §1.381(c)(16)-1) after the date of distribution or transfer, the deductibility of such an item is determined under this section if it is not deductible under section 381(c)(16) and the regulations thereunder. The amount of the adjustments necessary to reflect a change in accounting method pursuant to this section, the manner in which they are to be taken into account, and the tax attributable thereto shall be determined and computed under section 481 and the regulations thereunder, subject to the rules provided in paragraphs (c) and (d) of this section. Where such change is a change from the accrual to the installment method by a dealer in personal property, section 453(c) and the regulations thereunder apply.

* * * *

[26 C.F.R. 1.381(c)-4.]

Rev. Rul. 57-482

In accordance with a plan of complete liquidation adopted after June 22, 1954, a corporation sold its assets, including accounts receivable at face value, in a transaction on which no gain or loss is recognized to the corporation under section 337 of the Internal Revenue Code of 1954. However, there remained, on the books of the corporation, a reserve for bad debts which had at all times been reasonable and necessary and which had been accumulated by additions for which the taxpayer derived full tax benefits in prior taxable years. *Held,* the reserve for bad debts constitutes ordinary income to the corporation in its final Federal income tax return, since the need for maintaining the reserve ceased when the taxpayer disposed of the accounts receivable. See *Geyer, Cornell & Newell, Inc.* v. *Commissioner,* 6 T.C. 96, acquiescence, C.B. 1946-1, 2. The fact that no gain or loss on the sale of the assets was recognized to the corporation pursuant to section 337 of the Code does not have any bearing upon the realization of income by the corporation when the need for maintaining the reserve for bad debts ceased.